

# Keeping up with Retail Access? Developments in U.S. Restructuring and Resource Procurement for Regulated Retail Service

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*Retail access states have been reaching a key milestone: the end of the initial "transition period," after which utilities generally are required to use competitive processes to procure supply for their continuing obligation to provide retail service at regulated rates. The authors present a survey of the current state of U.S. retail restructuring, discuss the policy challenges faced as the initial transition periods end, and document how distribution utilities are procuring power for customers who have not selected alternative suppliers.*

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## I. Introduction

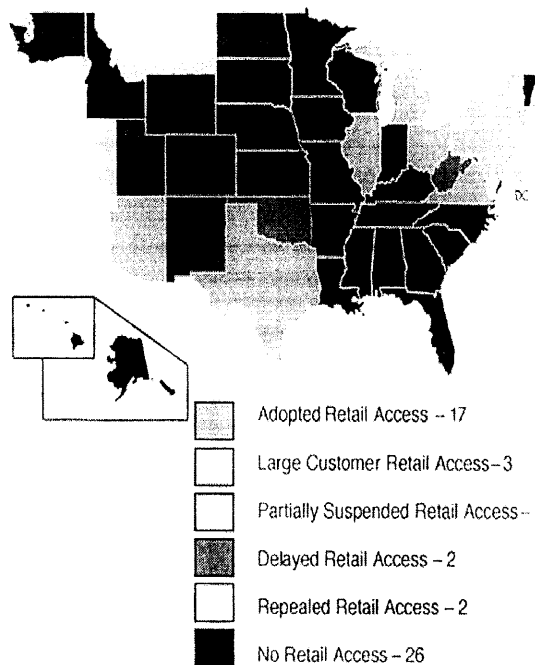
The dividing line between states that have pursued retail restructuring and states that are staying with traditional regulation has become more pronounced and possibly solidified. States that

embraced retail access continue to do so and are reaching important milestones in meeting customers' continuing needs. Meanwhile, states with a traditional utility industry structure have ceased looking toward retail access and are finding ways to combine retail

regulation with wholesale competition. In retail access states, a clear trend has emerged: Large customers are quite active in selecting service from unregulated suppliers, while residential and other small customers demonstrate a pronounced tendency to remain on the regulated retail service provided by the distribution utility.

A common challenge facing retail access states is the end of the so-called "transition period," during which retail customers who did not select service from an unregulated supplier could obtain regulated service from the distribution utility as the "provider of last resort" (POLR). During this period, regulated service was generally offered at capped rates with resources provided through buy-back contracts with the distribution utilities' generation affiliates or new generation owners. As this transition period comes to an end, policymakers and utilities have to address the continued need for regulated retail service and the procurement of generation supplies to provide that service. The way that this procurement process is structured has important implications for customer rates, utility cost recovery, the liquidity of wholesale markets, and the creation of a level playing field for unregulated retail access providers.

## II. Status of Retail Restructuring in the U.S.



Source: EEI, Energy Central, The Brattle Group.

Figure 1: Summary of Retail Access in the U.S. (2004) Source: EEI, Energy Central, The Brattle Group

movement that has gained broad, but certainly not universal, support of state policymakers starting in the mid-1990s. In total, 25 states (including the District of Columbia)<sup>1</sup> have initiated a policy of utility industry restructuring through open retail access. Of these, 21 states are at present supporting retail access for all or some customer classes.<sup>2</sup> Four states have fallen away: Oklahoma and West Virginia have delayed their start dates of retail access, and Arkansas and New Mexico have repealed their retail access laws altogether.

Figure 1 shows a state-by-state summary of retail access. Table 1 provides a more detailed snapshot of the current status of retail access

access, listing states in the chronological order in which retail access was inaugurated. Table 1 indicates that the transition from a traditional, regulated industry structure to retail access was almost universally accompanied by a multi-year transition period. During this transition period, states dealt with three restructuring-related goals: (1) stranded cost recovery, (2) restructuring of generation ownership, and (3) protection of retail customers through continued provision of a regulated service option. These regulated service options are referred to as "standard offer service," "default service," "provider of last resort," and "basic generation service," although the precise meaning of

**Table 1: Current Status of Competitive Market Development in States (Sorted by Inception Date of Retail Access)**

	State	Inception of Retail Access	Customers Open to Retail Access as of 2004	Existence and Status of Capped Rates for Generation	Retail Access Penetration (% of MWh)***
[1]	Rhode Island	1/1998	All customers	Standard offer effectively capped until 2009 with fuel adjustment clause; last resort service is market-based since 6/2000	11%
[2]	Massachusetts	3/1998	All customers	In effect with fuel adjustment for Standard Offer through 2/2005; None for Default Service	23% (2% R; 35% NR)
[3]	California	4/1998 (suspended in 2001)	Only customers that were exercising retail choice prior to 10/01	Rate Freeze ended in 2001	13% (1% R; 20% NR)
[4]	New York	1998–2001 (varies by utility)	All customers	Varies by utility	23% (5% R; 33% NR)
[5]	New Jersey	11/1999	All customers	Ended July 2003	18%
[6]	Pennsylvania	1/2000	All customers	Varies by utility	11% (6% R; 15% NR)
[7]	Maine	3/2000	All customers	None	38% (0% R; 56% NR)
[8]	Connecticut	7/2000	All customers	Initial cap ended 12/2003; new cap in effect for Transitional Standard Offer period (1/2004–12/2006)	n/a
[9]	Maryland	7/2000	All customers	Varies by utility	16% (4% R; 29% NR)
[10]	Delaware	10/2000	All customers	2005–2006	n/a
[11]	D.C.	1/2001	All customers	In effect through 1/2005	33% (11% R; 38% NR)
[12]	Ohio	1/2001	All customers	Varies by utility	20% (18% R; 21% NR)
[13]	Arizona	1/2001	All customers	Varies by utility	n/a
[14]	Illinois	1/2001 (for non-residential customers)	All customers	In effect through 12/2006	24% (0% R; 34% NR)
[15]	New Hampshire (PSNH-Specific)	5/2001	All customers	2/2004 (Transition Service rate becomes a negotiated rate)	n/a
[16]	Nevada	7/2001 (for large C&I with 1 MW of demand)	Large C&I with 1 MW of demand	None	n/a
[17]	Michigan	1/2002	All customers	2005 and 2006 for small commercial and residential	11% (0% R; 16% NR)

Table 1: (continued)

	State	Inception of Retail Access	Customers Open to Retail Access as of 2004	Existence and Status of Capped Rates for Generation	Retail Access Penetration (% of MWh) <sup>***</sup>
[18]	Texas	1/2002	All customers	"Price to beat" capped until 1/2007	43% (10% R; 62% NR)
[19]	Virginia	1/2002 (many Dominion Power customers delayed access until 2003)	All customers	7/2007	n/a
[20]	Oregon	3/2002	Only C&I customers with 1 MW of demand or more	None	7.3% of PGE's non-residential load
[21]	Montana	7/2002	Large customers (HB509 effectively assigns small customers to default provider until 2027)	Expired on 7/2002	n/a

Sources and Notes: EIA, state public utility commissions, FTC summaries, company 10-Ks and NARUC.

<sup>\*\*\*</sup> "R" indicates residential; "NR" indicates non-residential; "n/a" indicates not available or unknown. Switching data collected from recent postings on commission sites.

This transition period simultaneously provided time for competitive suppliers to develop packages of services that would appeal to the millions of small and large customers, to contact those customers, and to present market-based offers. A bundled, regulated, set-price offer of generation service was generally to be provided to serve as the interim offer until customers voluntarily switched to unregulated suppliers. Such regulated service would also be available if a competitive supplier suddenly discontinued its service to a customer or if customers wanted to return to regulated service. These regulated rates were offered over the entire initial transition period that generally lasted from three to 10 or more years—with the length of the period often determined by the need to collect utilities' stranded costs.

The pricing of the regulated service option was driven by restructuring policy and often consisted of rate freezes or capped rate paths. Policymakers in these states wanted to ensure that the highly visible regulated service offer provided some demonstrable benefits (i.e., a rate reduction) when competition was initiated. A partially unintended consequence was that this price affected the attractiveness (or lack thereof) of obtaining service from unregulated retail providers.<sup>3</sup>

To meet the utilities' regulated supply obligation service at capped rates, "buy-back" agreements tied to the regulated price were generally signed between the distribution utility and the generation assets that were being divested or transferred to unregulated subsidiaries.<sup>4</sup> This combination of

rate freeze (or capped rates) and buy-back agreements with restructured generation assets during the initial transition period generally also meant that many of the restructured states did not immediately need to focus on how distribution utilities would procure resources for regulated service options once the transition-related contracts expired.

As the initial transition period has been or is about to be completed in the majority of retail access states, a new framework for utilities' continued provision of regulated service options was needed and has emerged. This post-transition framework requires resolution on two major policy issues:

- The type and pricing of regulated services (i.e., determination of the future availability, pricing, scope,

duration, and other terms and conditions of regulated service options); and

- Resource procurement for these regulated services (i.e., establishment of an effective process for procuring the generation resources to support the post-transition regulated service options).

### III. The Need for Continued Provision of Regulated Service Options

The factual record on retail access shows that customers' selection of alternative retail providers has generally progressed more slowly than initially expected. There are two patterns that emerge. First, the majority of total retail load is still on the uti-

lities' regulated service offering. As Table 1 shows, two to seven years after the introduction of retail access, as little as 11 percent (Rhode Island and Pennsylvania) but no more than 43 percent (Texas) of total customer load has switched to unregulated retail providers. This "penetration" or size of unregulated retail market (measured in percentage of total MWh sold through unregulated suppliers) also shows that there is no correlation with the age of a state's retail access market (Figure 2). Second, as Figure 3 shows uniformly across retail access states, large non-residential customers have switched to alternative retail suppliers in much greater numbers than residential and small non-residential customers. While average state-wide retail access penetration for non-residential customers ranges

from 15 percent to 62 percent, retail access penetration generally is still less than 10 percent for the residential class (which typically represents about 30 percent to 40 percent of total load but 90 percent of all customers).

This experience has important implications as we near the end of states' transition periods. Since large numbers of customers cannot make switching decisions overnight, some form of regulated service offer continues to be needed for at least utilities' residential and small non-residential customer classes. Of course, lack of switching may be in part be explained by frozen regulated retail rates below the market-based rates that alternative suppliers could offer. Such below-market pricing is generally not sustainable after the buy-back contracts expire. Therefore, most

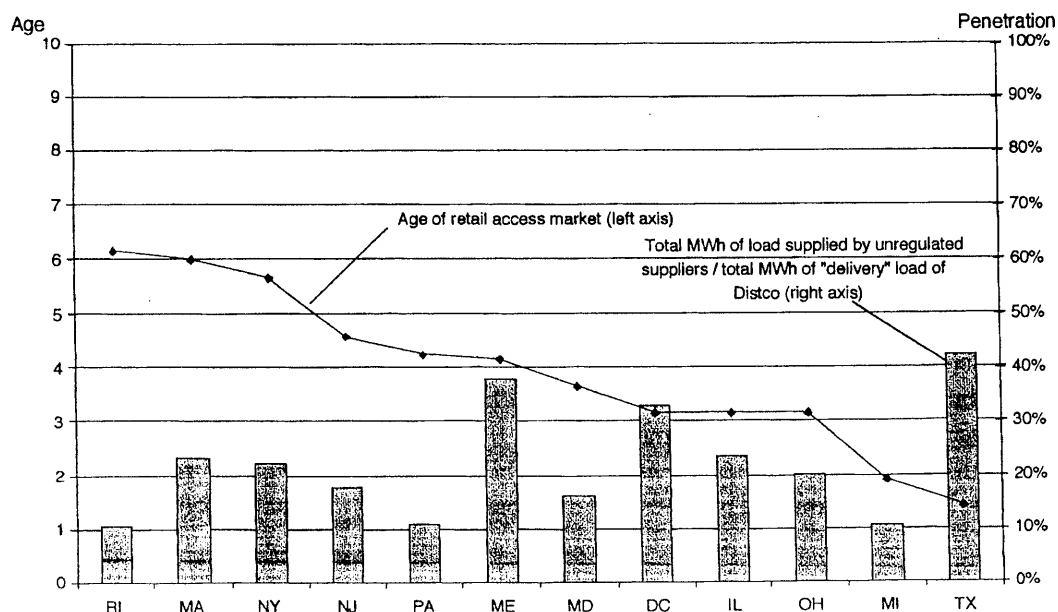


Figure 2: Age of Retail Access vs. Retail Access Penetration (2004)

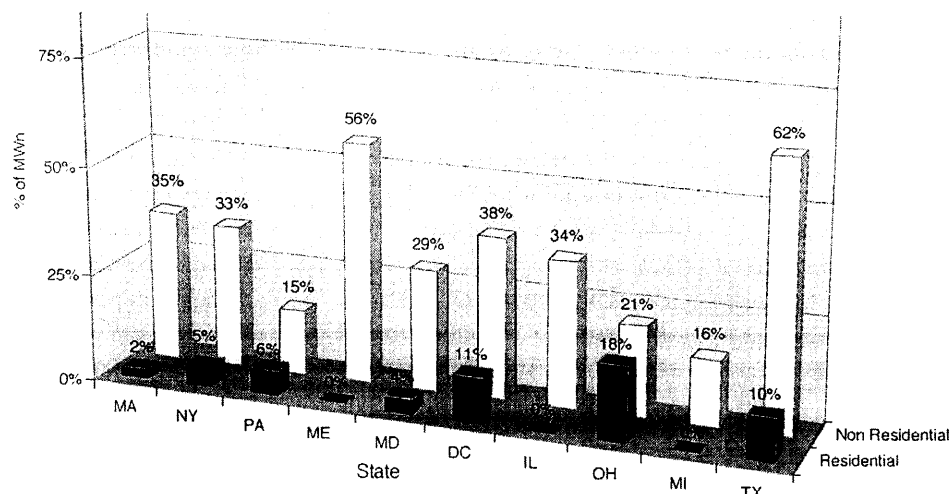


Figure 3: Residential vs. Non-Residential Retail Access Penetration (2004)

policymakers have concluded that the rates for "post-transition" regulated service options need to be reflective of market prices. This immediately also raises the question of how generation supply for these service offerings should be procured by the distribution utilities.

#### IV. Resource Procurement for Regulated Service Options

Many industry participants and policymakers agree that the objective of supplying post-transition regulated service options at market-based, competition-enhancing prices is best met through transparent, Commission-approved, competitive procurement processes that are open to a diverse group of suppliers. Such procurement processes will

not only lead to appropriate pricing of the utilities' regulated service options, but will also enhance wholesale market competition. This also maintains a level playing field in which unaffiliated generation supplies are neither unduly advantaged nor disadvantaged in the procurement process relative to utilities' own generation or marketing affiliates.

We have reviewed competitive procurement approaches to supply utilities' post-transition regulated service options and found that there are two general procurement models, which we labeled:

- the *standard offer approach* and
- the *portfolio management approach*.

Under the standard offer approach, the regulated utility competitively procures power under standardized full-requirements contracts, each of

which either supplies a defined portion (e.g., a fixed percentage) of the utilities' regulated service obligation or a defined set of customers. As a result, wholesale suppliers (not the distribution utilities) assume the day-to-day responsibility of resource procurement and portfolio/risk management functions for the distribution company's regulated service load. The utility's role primarily involves developing a competitive procurement process, obtaining state regulators' approval of the plan, and executing the process, generally on an annual basis.

In contrast, under the portfolio management approach, the utility retains the day-to-day responsibility for directly procuring resources, managing price and volume risks, and providing full-requirements, load-following service for its regulated service customers. This

would generally be done according to Commission-approved processes. The contracts within the utility's portfolio could be a variety of energy and capacity products (e.g., baseload, peak-load, capacity release option, load-following, and ancillary-service contracts) of various durations and flexible pricing methodologies tailored to meet the expected demand for regulated service at reasonably stable costs.

**T**he summary and comparison of the resource procurement approaches utilized in the identified 21 retail access states is presented in **Table 2**. The table is organized in three sections: (1) nine states which generally use the standard offer approach to post-transition procurement of regulated service supplies; (2) six states that use

variations of the portfolio management approach for such procurement; and (3) six states that either cannot easily be categorized into one of the two general approaches or have not yet made a decision on post-transition procurement methodology.

## V. Experience with Resource Procurement for Regulated Service

As shown in Table 2, there are nine states that already use or have selected the **standard offer approach**. They include Connecticut, the District of Columbia, Maine, Maryland, Massachusetts, Rhode Island, Texas, New Jersey, and Ohio. The Ohio commission has selected the standard offer approach as the default procurement method for the state's

jurisdictional utilities, but is allowing utilities to propose alternative approaches. Texas uses a standard offer approach only for its "provider of last resort service" (the only safety net service for large customers and the backup service to the price-capped "price-to-beat" service offered to smaller customers), which is in place through January 2007.

**T**hese standard offer approaches share important similarities, including:

- The product procured is a full-requirements, load-following service for a share of the utilities' continued regulated service obligation;
- Much of customer switching risk is transferred to bidders;
- A tradeoff between rate stability and rates that are reasonably reflective of market

**Table 2: Competitive Procurement Approaches for Regulated Service in Retail Access States (Grouped by Procurement Approach)**

	State	Commencement of Competitive Procurement of Regulated Generation Service	Generation Divestiture*	Approach to Procurement of Regulated Generation Service**	Primary RTO
[1]	Connecticut	1/2004 (procurement for transitional standard offer	Complete	Standard Offer	ISO-NE
[2]	D.C.	2/2005	Complete	Standard Offer	PJM
[3]	Maine	3/2000	Complete	Standard Offer	ISO-NE
[4]	Maryland	7/2004	Mixed	Standard Offer	PJM
[5]	Massachusetts	3/2005	Complete	Standard Offer	ISO-NE
[6]	Rhode Island	6/2000 (Last Resort service)	Complete	Standard Offer	ISO-NE
[7]	Texas	1/2007	Transferred to affiliates	Standard Offer	ERCOT
[8]	New Jersey	8/2002	Mixed	Standard Offer	PJM
[9]	Ohio	1/2006	Transferred to affiliates	Standard Offer is default method (alternatives may be proposed by utilities)	MISO & PJM

Table 2: (continued)

	State	Commencement of Competitive Procurement of Regulated Generation Service	Generation Divestiture <sup>*</sup>	Approach to Procurement of Regulated Generation Service <sup>**</sup>	Primary RTO
[10]	California	1/2003 (under the new Generation Procurement policy)	Partial	Portfolio management for loads no longer subject to retail access	CAISO
[11]	Montana	7/2002	Complete	Portfolio Management	None yet
[12]	Arizona	Procurement commenced in 3/2003 for delivery starting in 2003	Originally planned, but cancelled	Portfolio Management and Regulated Utility- Owned Generation	None yet
[13]	Nevada	Ongoing responsibility for the Eligible Large C&I	Originally planned, but cancelled when residential and small C&I access	Portfolio Management and Regulated Utility- Owned Generation	None yet
[14]	Oregon	3/2002	Partial	Portfolio Management and Regulated Utility- Owned Generation	None yet
[15]	New York	7/2001	Virtually complete	Variations of Portfolio Management (Divestiture- related fixed and variable- priced long-term contracts supplemented with spot purchases and hedging contracts)	NYISO
[16]	Pennsylvania	1/2000	Transferred to affiliates	Mixed (Some competitive solicitation to serve retail customers, but mostly purchased from affiliates at capped rates determined in initial settlement)	PJM
[17]	Delaware	2005-2006	Complete	TBD	PJM
[18]	Illinois	1/2007	Mixed	TBD	MISO & PJM
[19]	Michigan	TBD	Mixed; Once a market power threshold reached, transfer must occur	TBD	MISO
[20]	New Hampshire (PSNH-Specific)	2/2006	Delayed until end of Transition Service	TBD	ISO-NE
[21]	Virginia	7/2007	Transferred to affiliates	TBD	None yet

**Sources and Notes:** EIA, state public utility commissions, FTC summaries, company 10-Ks and NARUC (as of mid 2004).

<sup>\*</sup> "Mixed" means that some utilities completely divested, while others transferred to affiliates or partially divested. "Partial" means that utilities divested part of their generation portfolio.

<sup>\*\*</sup> "Standard Offer" means regulated utilities competitively procure full requirements contracts for a fixed percentage of regulated generation load or a defined set of customers. "Portfolio Management" means regulated utilities competitively procure capacity, energy, and risk management products to provide full requirements service for regulated generation load.